TENNESSEE DEPARTMENT OF REVENUE
REVENUE RULING #98-02

WARNING

Revenue rulings are not binding on the Department. This presentation of the ruling in a redacted form is information only. Rulings are made in response to particular facts presented and are not intended necessarily as statements of Departmental policy.

SUBJECT

Whether a real estate investment trust and its two subsidiaries should be disregarded as separate entities for Tennessee franchise, excise tax purposes and whether a qualified real estate investment trust subsidiary that is a limited partner in a partnership doing business in Tennessee is subject to franchise, excise taxes.

SCOPE

Revenue Rulings are statements regarding the substantive application of law and statements of procedure that affect the rights and duties of taxpayers and other members of the public. Revenue Rulings are advisory in nature and are not binding on the Department.

FACTS

The Taxpayer is a foreign corporation that is qualified as a real estate investment trust (REIT) for federal income tax reporting purposes pursuant to I.R.C. § 856. The Taxpayer has two wholly owned subsidiaries, Sub 1 and Sub 2, that are "qualified REIT subsidiaries" under I.R.C. § 856(i). As qualified REIT subsidiaries, Sub 1 and Sub 2 are disregarded as separate taxable entities for federal reporting purposes and are treated as divisions of the Taxpayer.

Sub 1 is an 84% limited partner in a limited partnership (LP) that owns and operates apartment complexes in several states including Tennessee. As a limited partner, Sub 1 is only a passive investor in LP. Sub 1 exercises no power or control over LP and does not participate in any way in the management of LP. Sub 2 owns a 1% general partnership interest in LP. The remaining 15% of LP is held by third party investors as limited partners.

Aside from Sub 1 and Sub 2's limited and general partnership interests in LP and the Taxpayer's indirect interest in LP through its ownership of Sub 1 and Sub 2, neither the Taxpayer, Sub 1, or Sub 2 have any business contacts or business activities in Tennessee.

Neither Sub 1 nor Sub 2 are incorporated in Tennessee. As a general partner in a partnership doing business in Tennessee, Sub 2 will qualify to do business in Tennessee. Accordingly, Sub 2 will have a Tennessee franchise, excise tax filing obligation.

However, Sub 1, as a limited partner in a partnership doing business in Tennessee, will not qualify to do business in Tennessee.

QUESTIONS PRESENTED

1. For Tennessee franchise, excise tax purposes, will the Taxpayer be treated as a corporation separate from Sub 1 and Sub 2?

2. Is the Taxpayer doing business in Tennessee so as to be subject to Tennessee franchise, excise taxes?

3. Is Sub 1 doing business in Tennessee so as to be subject to Tennessee franchise, excise taxes?

RULING

1. Yes.

2. No.

3. No

ANALYSIS

1. For Franchise, Excise Tax Purposes, The Taxpayer Is A Corporation Separate And Independent From Its Qualified REIT Subsidiaries

Title 26 U.S.C.A. § 856(i), set forth below, defines a qualified REIT subsidiary and provides that, for federal tax purposes, it is treated as a division of its parent rather than as a separate corporate entity.

> (i) Treatment of certain wholly owned subsidiaries.
> (1) In general. For purposes of this title- -
> (A) a corporation which is a qualified REIT subsidiary shall not be treated as a separate corporation, and
> (B) all assets, liabilities, and items of income, deduction, and credit of a qualified REIT subsidiary shall be treated as assets, liabilities, and such items (as the case may be) of the real estate investment trust.
> (2) Qualified REIT subsidiary. For purposes of this subsection, the term 'qualified REIT subsidiary' means any corporation if 100 percent of the stock of such corporation is held by the real estate investment trust at all times during the period such corporation was in existence.
> (3) Treatment of termination of qualified subsidiary status. For purposes of this subtitle, if any corporation which was a qualified REIT subsidiary ceases to meet the requirements of paragraph (2), such corporation shall be treated as a new corporation acquiring all of its assets (assuming all of its liabilities) immediately before such

> cessation from the real estate investment trust in exchange for its stock.

T.C.A. §§ 67-4-806 and 67-4-903 impose franchise, excise taxes on "All corporations, cooperatives, joint-stock associations and business trusts, including regulated investment companies and real estate investment trusts, organized for profit . . . and doing business in Tennessee . . .". The Taxpayer, Sub 1 and Sub 2 are three individual, separately chartered corporations. Because the Taxpayer is a REIT and its two subsidiaries are qualified REIT subsidiaries, Title 26 U.S.C.A. § 856(i) treats them as one corporation for purposes of federal income taxation.

Although, under T.C.A. § 67-4-805(a), the starting point for determining net earnings for Tennessee excise tax purposes is federal taxable income before the net operating loss deduction and special deductions, nothing in Tennessee's franchise, excise tax statutes (T.C.A. §§ 67-4-801 et seq. and 67-4-901 et seq.) require or permit the use of the federal classification of a business entity for franchise, excise tax purposes.[1]

With the exception noted in footnote 1 below, T.C.A. §§ 67-4-806 and 67-4-903 are applied to the business entities named therein in accordance with the way such entities are legally classified without regard to how they may be classified for federal income tax purposes.

TENN. COMP. R. & REGS. 1320-6-1-.02(2) requires franchise, excise tax returns to be filed to coincide with each accounting period for which a federal return has been filed. *DAACO, Inc. v. Huddleston*, 891 S.W.2d 920 (Tenn. App. 1994), permission to appeal denied by Supreme Court 1-30-95. For federal income tax filing purposes, it may be that a corporation is considered to be a division of its parent or is included in the consolidated federal return filed by its parent. However, under T.C.A. § 67-4-805(a), the starting point for computing its net earnings for Tennessee excise tax purposes is the pro forma federal net earnings, before the net operating deduction and special deductions, that the corporation would have had if it had been filing on a separate entity basis for federal income tax purposes.

The Taxpayer, Sub 1 and Sub 2 are each separately chartered legal entities and, as such, they must be so classified for Tennessee franchise, excise tax purposes.

2. The Taxpayer Is Not Doing Business In Tennessee So As To Be Subject To Franchise, Excise Taxes

The Taxpayer has no business contacts or activities in Tennessee. It owns 100% of the stock of Sub 1 which, as is discussed below, is not doing business in Tennessee for franchise, excise tax purposes. It also owns 100% of the stock of Sub 2 which, as is

[1] T.C.A. § 48-211-101 does require the federal income tax classification of a Limited Liability Company to be followed for all state and local tax purposes, including the franchise, excise tax. However, this is the sole instance in which the federal income tax classification of a business entity is required or permitted for franchise, excise tax purposes. T.C.A. § 67-4-805(a)(3) requires unitary financial institutions, as defined by T.C.A. § 67-4-804, to file combined franchise, excise tax returns, but such returns would not necessarily include the same business entities included in a combined return for federal income tax purposes.

correctly stated in the FACTS above, is doing business in Tennessee so as to be subject to franchise, excise taxes.

The Taxpayer only has an investment in the stock of a corporation, Sub 2, that is doing business in Tennessee so as to be subject to franchise, excise taxes. Sub 2's Tennessee activities as a result of its general partnership interest in a partnership doing business in Tennessee can not be attributed to the Taxpayer solely as a result of the fact that it owns 100% of Sub 2's stock.

The Taxpayer has no business activities in Tennessee and thus, is not subject to Tennessee's franchise, excise taxes.

3. Sub 1 Is Not Doing Business In Tennessee So As To Be Subject To Tennessee Franchise, Excise Taxes

For many years the Tennessee Department of Revenue has taken the position that a foreign corporate limited partner is not doing business in Tennessee so as to be subject to Tennessee corporate franchise, excise taxes if its activities are limited as follows:

> (1) The corporate limited partner's only business activity in Tennessee is the holding of a limited partnership interest in a partnership(s) with nexus in Tennessee; and
>
> (2) The corporate limited partner exercises no power, management or control over the partnership(s) except such powers or capacities outlined in T.C.A. § 61-2-302 which limited partners may exercise without participating in the management or control of a partnership.

A foreign corporate limited partner's involvement in a partnership doing business in Tennessee appears to be similar to the interest of a foreign corporation whose only Tennessee activity is that of a stockholder in a corporation doing business in Tennessee. Neither the limited partner nor the stockholder have the right to participate in the management or control of the partnership, or corporation, as the case may be, and thus neither are said to be "doing business" in Tennessee so as to be subject to corporate franchise, excise taxes imposed by T.C.A. §§ 67-4-901 et seq. and 67-4-801 et seq. The Department's policy with regard to this matter considers a foreign corporate limited partner in a partnership having nexus in Tennessee as having only a passive investment in Tennessee just as does a foreign corporate stockholder in a corporation having nexus in Tennessee. Such a passive investment would not create sufficient tax nexus for Tennessee to impose corporate franchise, excise taxes.

It would be possible for a foreign corporate limited partner in a partnership having nexus in Tennessee to engage in other transactions in Tennessee, either with the limited partnership itself, or with other parties, that would result in sufficient Tennessee minimum contacts to subject it to corporate franchise, excise taxes. For example, such a foreign corporate limited partner that also has a general partnership interest in a partnership with Tennessee nexus, or that has Tennessee activities that are not protected by Title 15 U.S.C.A. §§ 381-384, would be subject to Tennessee franchise, excise taxes.

When a foreign corporate limited partner has nexus in Tennessee due to activities other than its limited partnership interest, T.C.A. §§ 67-4-910 and 67-4-811 require inclusion of the foreign corporation's share of partnership property, payroll and sales in its apportionment formula.

Sub 1 is not incorporated in Tennessee and has no Tennessee certificate of authority to transact business or conduct affairs in Tennessee. It is neither legally nor commercially domiciled in Tennessee. Sub 1 states that it is only a passive investor in LP and, as such, does not exercise any power or control over the partnership and does not participate in the partnership's management in any way.

Under the facts presented, Sub 1 will not be subject to Tennessee franchise, excise taxes and will not be required to file a franchise, excise tax return.

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Arnold B. Clapp, Senior Tax Counsel

APPROVED: _____
Ruth E. Johnson, Commissioner

DATE: 1-8-98